

W P Smith¹

South African wine farm valuation: A methodical approximation

Abstract

In recent years obvious changes have taken place regarding the valuation of wine farms (and other farms) in South Africa. The value of the rand declined strongly against other world currencies, for example the American dollar and the pound sterling. Many foreigners used this opportunity to buy farms, especially wine farms, in South Africa. The current poor exchange rate has drastically influenced the value of these farms. Unreasonably high prices paid for a property destabilise the market and influence the property value of adjacent farms. The poor exchange rate as well as other factors e.g. the location, the state of the infrastructure and the current goodwill, to a large extent influence the final sales price, and thus focus on local property valuation methods.

Keywords: Farm valuation, South Africa, property value.

SUID-AFRIKAANSE WYNPLAASWAARDASIE: 'N METODIESE BENADERING

Die waardasie van wynplase, en ander plase, het die afgelope paar jaar 'n wending geneem. Dit kan toegeskryf word aan die relatiewe swak waarde van die rand teenoor ander geldeenhede soos die Amerikaanse dollar en die pond sterling. Heelparty buitelanders maak van hierdie geleentheid gebruik om wynplase in Suid-Afrika te bekom. Ander waardebepalende faktore speel ook 'n rol in die bepaling van die verkoopprijs van hierdie plase, soos onder meer die fisiese aard van die grond, die bestaande infrastruktuur en die klandisiewaarde wat aan die plaas gekoppel is.

Die waardasie-metode wat gevolg word is uiters belangrik. Dit is duidelik dat hierdie metode weldeurdag moet wees, veral weens bestaande wisselvallighede ten opsigte van sake wat in berekening gebring moet word. In Kanada word byvoorbeeld daarop aangedring dat al drie basiese waardasie-metodes toegepas word ter verkryging van 'n meer betroubare antwoord, terwyl plaaslike waardeerders bloot die resultaat van 'n waardasie hoef te toets teen 'n alternatiewe waardasie-metode. Die waardasie van elke wynplaas moet eerder as 'n unieke geval gehanteer word en 'n deeglike studie behoort van elke eiendom gemaak te word, ongeag watter metode gevolg word.

Sleutelwoorde: Plaaswaardasie, Suid-Afrika, eiendomswaardering.

1. Willem P Smith, Nat. Dip. Building (CT) B Tech(QS) (CT) M Tech(QS) — Property Valuation (CT). Ph D in Quantity Surveying in process (UFS). MASAQS.

1. Introduction

1.1 The subject matter

A detailed study of the process of wine farm valuation to cover all its aspects is essential. However, this is not the aim of this article. This article focuses on the basic principles of wine farm valuation rather than on specialised scientific analysis. No attempt is made to provide a detailed explanation of the academic terminology and definitions of property valuation with respect to:

- Finance
- Highly specialised aspects influencing the market value
- Economy.

1.2 Terminology of basic principles

Excellent books on property valuation in general are available and by consulting some of these sources the reader can acquire a sound knowledge of all terminology regarding the basic principles of property valuation as indicated in the bibliography.

1.3 The aim of this research

This article may be useful to legal advisors in terms of wine farm valuation, to wine farmers, and to other role-players. People without the scientific knowledge regarding the basic aspects of property valuation may also benefit since the article raises the latest issues regarding wine farm valuation in South Africa.

1.4 The problem

Very little research has been conducted on the topic of wine farm valuation in South Africa. Information on the subject of local wine farm valuation has only recently become available, though many American authors have shared their thoughts on this and similar subjects in the past. South African property appraisers can benefit from the experience and knowledge of their overseas peers.

One of the most prominent figures in property appraisal in the world, the late R U Ratcliff (1972: 5) commented on the subject as follows:

Neither the adequacy of the market information which the appraiser can adduce nor the analytical techniques at his command will permit him to make a prediction of market price which is certain of exact realization should the property be exposed for sale. Appraisal is an economic analysis under

conditions of uncertainty and its findings can be expressed only in probabilistic terms.

Upon careful consideration of the above-mentioned statement, it is obvious that notwithstanding the quality of the information obtained, there is always the probability that the end result may vary. This exacerbates problems experienced by appraisers worldwide. The one factor that aggravates the local situation is the lack of factual written information.

By consulting leading figures in property valuation in South Africa, it is possible to highlight some issues regarding the process of valuation. Valuers compiled a questionnaire during wine farm valuations. The list varies in some instances depending on the information available at the time of valuation, and includes some of the following questions:

- What method of valuation is best when valuing wine farms?
- What factors mostly influence the value of farms?
- Can an improved method of valuation regarding wine farms be derived or are the current methods adequate?
- Does the fact that specialised wine farms are seldom appraised, force these properties into the so-called 'specialised property' segment of the market, or can all wine farms be considered as an entity of one type and be valued accordingly?

1.5 Physical factors contributing to the farm's value

The most important contributing factors to the wine farm's value are the physical conditions of the property. The factor that has the greatest influence on property value is the location of the farm. This is true for most properties. The better the location, the greater the value. The location of a property is directly related to its market price. Only a limited 'supply' of areas are suitable for wine-farming in South Africa and all the available land in these areas is usually developed into wine farms, making it difficult for prospective developers to find other suitable land.

In South Africa some of the few good locations for grape production are: the Boland, Hex River Valley, Orange River District and some districts in the Western Cape. This scenario 'forces' a prospective farmer to buy a developed farm. It can be stated that the market for wine farms is based on scarcity. AIREA (1983:311-312) has the following opinion regarding 'scarcity':

... [I]f demand is constant, the scarcity of a commodity makes it more valuable. Land, for example is still generally

Smith/South African wine farm valuation

abundant, but useful, desirable land is relatively scarce, and therefor has greater value. No object, including real property, can have value unless scarcity is coupled with utility. Air, which has a high level of utility, has no definable economic value because it is abundant.

Many physical factors influence the production of wine and contribute to the value of the farm in the sense that they complement the location of a specific farm. Farms producing grapes for wine-making must be situated in the right climate zone. Normally, the hotter the climate, the sweeter the grapes produced. Cultivars for the production of *Chardonay* and *Cabernet*, the drier wines, thrive for example in the Boland district.

Wine farms should have suitable soil conditions including an abundant water supply for irrigation purposes. Climatic conditions, such as frost, may have a devastating effect on a harvest, and cultivars such as *Colombar* that are easily affected, even by mild frost, must therefore be planted on higher ground. Because of the limited sunshine, slopes and locations in Europe are carefully examined to find the right spot for each of the various cultivars.

We do not experience this problem in South Africa, but farmers may consider planting cultivars such as *Riesling* in cooler areas and cultivars such as *Shiraz*, *Bukettraube* and *Colombar* in those areas protected from wind and frost. It is obvious that many physical factors influence the value of a wine farm, thus aggravating matters further.

2. Methods used in the valuation of wine farms

Hofmeyer (1997) states that valuation in South Africa seldom differs from that in overseas countries. However, we must bear in mind that certain aspects relating to valuation in South Africa are different. It is true that the basic principles are similar, but some form of change is necessary to accommodate our specific needs. Hofmeyer (1997) indicates that each valuation must be analysed individually. The final decision on the specific method to be used must only be made once all information concerning the property has been considered.

Canadian laws prescribe, for example, three major appraisal methods. By implementing this policy they hope to reduce human errors or faulty data used in a specific method. Some of the major banking groups in South Africa also use this procedure.

2.1 The comparable sales method

The basic principle for this method entails the use of data collected from the sale of comparable property. The properties must, however, be recently sold under bona fide market conditions. Many valuers see this method as the most reliable method of property valuation due to the fact that data from actual sales are used to compile a value of the relevant property. AIREA (1983:313) further states that the comparable sales method for property valuation has proved itself in many aspects of valuation throughout its history.

The greatest disadvantage of this method, however, is the non-availability of comparable sales, especially in the market for wine farms. Some districts, classified as traditional wine areas, experience a fairly good turnover under new management. In other districts wine farms seldom change hands and in these cases the valuer might find it difficult to obtain useful information to apply in his calculations.

Another factor to take into account is the time of a sale and when comparable sales are selected. It is useless to obtain information on property not sold recently. Fluctuations in the market can create a sudden escalation or drop in the value of wine farms. The performance of the wine-sales on the open market indicates to a large extent the value of the wine-producing estate. Ratcliff (1972: 252) states:

The price that a property will command in the market place reflects the expectations of buyers and sellers with respect to future productivity.

The above-mentioned statement should be considered carefully in the case of income-producing property. The main issue regarding the goodwill of wine farms is the impact of supply and demand on the market. Farms marketing popular wines will be more valuable to their owners than farms whose wines are currently not so popular. The effect of goodwill on the market-value of the farm can therefore be a useful tool, indicating the rise or fall in the generally assumed selling price. This will be dealt with in more detail in a discussion of the income capitalisation approach.

The application of the comparable sales method is fairly simple if information is available. To make the chosen sale comparable to the property in question, the valuer uses a matrix table comprising the utilities of the subject property of those recently sold. As such the valuer determines whether the subject property

Smith/South African wine farm valuation

or the comparable is more desirable and a range of values can be established. The most important issue, however, is the use of property reflecting good market data. Kinnard (1979: 101) describes sound market data as those that reflect the typical actions and reactions of buyers and sellers in the market place. Smith (1998: 135) emphasises this point by stating that the value of the result of the application of the comparable sales method depends mainly on the scrutinising skills of the valuer. Poorly chosen sales may cause the end result to shift to such an extent as to create the wrong perspective of the subject property.

Behrman (1995: 12) mentions the following typical points that need to be considered when judging comparable sales:

- The size of a farm
- The specific type of wine farm
- The date of sale
- The location
- The production capacity
- The extent of improvements to the farm.

Each of these characteristics affects the market value of the farm and must be carefully scrutinised before deciding on whether it is necessary to incorporate a specific point under consideration.

Wine farms do not sell as frequently as beef ranches or sheep farms. It all depends upon the district where the sale is taking place. In order to obtain information regarding farm sales, local estate agents and the deeds office must be consulted. The effectiveness of the comparable sales method of property valuation depends to a great extent upon the quality of data collected by the valuer.

When comparing properties, the appraiser has to decide on the nature of the variables between the comparable sales and the subject property. It is essential, according to AIREA (1983: 124), not to have too many variables because too many additions to and subtractions from the sales prices of both subject and comparable property tend to cause inaccuracies. AIREA (1983: 124) prefer those variables with the largest influence on sales prices.

One of the most common variables is the size of the farm. Sizes normally differ to such an extent that it is best to make small-scale comparisons rather than to take the entire property into account. The use of this method is, according to Smith (1998: 141), based on the comparison between units expressed in hectare and does not include additional value factors such as homesteads, cellars, etc. This tends to be the more popular version to date.

In addition it is necessary to emphasize the necessity to use only bona fide sales figures. When property economists analyse sales figures of farms in a certain district they usually apply the abnormal lease in or decrease in sales figures over a short period of time to incorrect methods or data used to appraise the property.

Farmers usually enquire how to improve the value of their wine estates. The answer to this question is simple. Because the sales comparisons approach to market valuation is most frequently used in South Africa, it would be wise to follow these indicators:

- Make sure that the physical condition of the farm is at its best, but over-capitalisation on physical features are not advisable.
- Plant only those cultivars that perform well in the target market.
- Farmers should not try and compete with other farms with specialised additions such as cellars and distilleries. These additions are expensive and need careful management in order to maintain their feasibility. It is surprising how many private cellars marketing their own brands of wine do not fare so well as they would have hoped to. However careful management and aggressive marketing can make such specialized additions one of the most valuable assets of a farm.
- Quality management is of the utmost importance.

Some physical factors are costly to improve. These improvements can lead to over-capitalization and must be avoided. It is necessary to look at the advantages and disadvantages of the sales comparison approach to wine farm appraisal. Here actual sales are compared. There are no statistics involved and the answer is based on recent market-related sales. This method is simple to grasp and easy to follow.

The main disadvantage of the comparable sales method is the fact that none of the comparable sales of wine farms used are alike. Every property has its own character and the additions and subtractions in value to make it 'comparable' to the subject property, have their risks. The availability of comparable sales can prove to be a problem, especially if no recent sales took place in the district where the subject property is situated. Maritz (1983:116) indicates that most often the appraiser has no inside information regarding surrounding sales transaction. This may affect the market value of the specific property. This method is however the most popular and user-friendly one with regard to wine farm valuation.

2.2 The income capitalisation method

AIREA (1983: 407) describes the income capitalisation method as follows:

The income capitalization approach to value is a procedure through which anticipated economic benefits are converted into a value estimate; it is a basic tool for the valuation of income-producing property.

The income capitalisation approach reflects the relationship between the annual net earnings of an interest in property and the value or sales price of that interest. It is based on the anticipation of buyers that the specific property might yield certain estimated profits in the future. In the valuation of wine farms the earnings from the land and the annual cash flow are the primary concern (AIREA, 1983: 408).

In projecting income, the valuer with a good knowledge of farming operations will provide better results since he is aware of those factors that impact on the income. It is important to note that farm income should not only reflect the current year's records, but also provide an average record of the past three to five years. The data from one year's income can be misleading, especially when that particular year proves to be a bad or exceptionally good year. On the other hand an average record of a few years can provide an inaccurate reading of the current trends in the market.

In order to be able to calculate gross and net income, the valuer has to understand the total economy of the farm. Knowledge of the essential factors regarding the calculation of gross and net income will enable him to interpret the available data. According to AIREA (1983: 408-409), production capacity and good management create gross income. To determine the quality and stability of the income stream, the property characteristics must be viewed against other similar properties in the area. Attention should be paid to both the management of the property and the current and anticipated trends in agricultural economy.

This method of wine farm appraisal can thus prove to be a useful tool, because wine farms are income-producing property. Kinnard (1979: 150) emphasizes this point and indicates that this method is used as a way to express the ratio between the annual net income and the possible sales price.

Murray (1969: 112) indicates several aspects regarding the use of the income capitalisation method of appraisal. The main issue of Murray's findings is that the appraiser must have a sound

knowledge of the type of property to be appraised. Some of the factors to investigate are: specific production capacity, the quality of the farm's management and access to capital. All these factors influence the income and must be carefully scrutinised. AIREA (1983: 423) indicates five steps in valuing property by implementing the income capitalisation method:

- Estimate the typical gross income
- Estimate the potential net income by subtracting the expenses from the gross income
- Determine the most appropriate capitalisation method
- Develop the appropriate ratios
- Complete the calculations.

The most important aspect of this method of property valuation is the research, which the appraiser completes before attempting to do any calculations (AIREA, 1983: 423).

2.2.1 Calculation of income

A wine estate can be managed in two ways: by ownership or by renting. When valuing the farm the valuer needs to investigate the typical ownership in the vicinity of the farm. According to AIREA (1983: 422), it is almost axiomatic that better management is attracted to better farms. In farming communities where good management is standard practice, above-average production usually follows. The opposite holds in the case of poor management. The net income or annual cash flow generated by a specific farm illustrates the debt-carrying capacity of the estate. This may have a significant impact on the sales terms. In South Africa there are more owner-operator farms than otherwise.

One of the most important considerations regarding the calculation of the net income of a wine farm is an intimate knowledge of the farming operations. A study of AIREA (1983: 420-422) reveals that the typical operations of farms can differ from district to district, and indicates that landlord-tenant income and expenditure is the most reliable method for applying the income capitalisation approach to rural property valuation, and states:

It is the most reliable and expedient method for extracting the specific income that is attributable to the real property itself. Consequently, this is the method most typically relied upon in rural appraisal.

It must, however, be borne in mind that the above-mentioned statement applies to the American situation as far as farm appraisal

is concerned. The use of a more comparable sales method might be preferable within the South African context.

a) Calculating gross income

Both Ratcliff (1979: 122) and AIREA (1983: 425) belong to the same school of thought when they describe the purpose of determining the gross income. According to them, the primary purpose is a step towards the calculation of the net income. AIREA (1983: 425) stresses the importance of determining whether the various cultivars planted on the farm actually represent the cultivars that prove to be popular in that particular district. The incorporation of new cultivars normally provides good results, and unknown or unfamiliar cultivars must be carefully considered. Grapevines may have a productive life of up to twenty years or more. Replanting with other cultivars could prove to be a costly exercise.

b) Calculating effective gross income

The effective gross income of farms can be seen as that income generated from all external sources such as subsidies from the government or from foreign sources. In the current economic times these subsidies will not have an effect, but must be dealt with as and when they do occur. Kinnard (1979: 132) stresses that no wine farm functions as a separate entity. It is incorporated in an existing system, which include labourers, the market places and the infrastructure of the surrounding areas. All these factors eventually have an effect on the value of a farm.

2.2.2 Analysing the expenses

In order to determine the net operating income of a farm, all expenses must be deducted from the gross income. It is essential to conduct a proper study to allow the valuer to make a sound valuation, not only of the direct expenses but also with regard to the indirect expenses such as possible improvements, to enable the farm to generate a larger income. Some of the expenses to be included in the valuation are: labour, insecticides, irrigation, tax, insurance on the harvest and the maintenance costs. The farmer can thus minimise these expenses by maintaining the structures on the farm or by concentrating on aspects that will reduce the expenses on for instance insurance. However, only those strategies that truly enhance the value of the farm must be implemented.

The next step in the income capitalisation approach to property valuation is to determine the net operational income. This refers to a calculation of all expenses over the past five years.

2.2.3 Capitalisation rate

The capitalisation rate refers to the likely proceeds generated by the implementation of a comparable method of investment. According to AIREA (1983: 418), the formula for determining the market value is expressed as follows:

Market value = Net operating income ÷ Capitalisation rate.

In the event of the valuation of a wine farm, where some of the additions such as specialised equipment have a short lifespan, two steps counteract the latter:

- A reserve addition to the income-expense statement that acts as a buffer to counteract rapid depreciation of an asset
- A component similar to the one indicated above, is implemented in the capitalisation rate, though this tends to have a negative impact on the value of a farm.

According to AIREA (1983: 419), it is interesting to note that the capitalisation rate is much higher in the case of owner-operated farms than otherwise, where the capitalisation rate tends to be higher. A higher capitalisation rate indicates a higher risk, but higher risks tend to yield higher profits.

The process for obtaining a capitalisation rate is not a simple one and should rather be left to professionals. Suter (1992: 145) indicates that the higher the capitalisation rates the lesser the value of the farm and vice versa. This issue can be illustrated in the history of farm sales in America in the seventies. At that time, the capitalisation rate was approximately 1,25% and the farm values were relatively high, but in the eighties, when the capitalisation rates rose to 7,5%, the value of those farms dropped accordingly. According to Behrmann (1995: 24) there are a few instances when a low capitalisation rate is preferred:

- If the subject property is family-owned and the likely buyer is to be the farmer and owner
- When the expected buyer indicates that he does not want the farm for monetary reasons only
- When the relevant property is a portion of a farm that is doing good business
- When the farm is adjacent to a wine-farming community
- If the farm is situated in an area where its physical assets are considered to be good.

The discounted cash-flow analysis is a more appropriate and more useful method of property valuation. This method is best applied when a computer is used in the process of valuation. As

Smith/South African wine farm valuation

with the previously mentioned methods, it largely depends upon the availability and the quality of data. The better the information received, the better the answer.

According to AIREA (1983: 420), the discounted cash-flow analysis calculates the amount, risk and timing of the estimated income by means of a specific time-related income projection. Each period's net income will be discounted to a present value by making use of an interest rate. The use of spreadsheets on a computer will simplify this process to a large extent.

2.3 The cost method

The basis of the cost approach of property valuation renders this method almost inappropriate for the valuation of wine farms. The main reason for not recommending this method of valuation for wine farms is that it is almost impossible to calculate depreciation. It can, however, be used when sufficient information is not available to implement the other two valuation methods.

When the normal depreciation formula is applied on a 300-year-old farm, the value of the farm will be considerably less than that of the same farm valued by using one of the other two methods. Most of the old farms are considered 'property with historical value' and are worth much more than some of the 'young farms with new buildings, and new irrigation systems'. According to AIREA (1983: 345), values derived from the cost approach are not supported by market information, and must be considered with caution.

In South Africa the tendency is to use professional quantity surveyors to 'value' structures. Experienced valuers for wine farms are scarce. Usually valuers derive the 'value' of a structure by estimating the replacement cost of the structures on the property. The building-depreciation is deducted from the reconstruction cost, and the answer indicates the 'value' of the structure. In the case of older properties, such as many wine farms, the term 'depreciation' poses problems.

3. What is considered good value for money?

The typical buyers of wine farms in South Africa are primarily interested in making a profit, and farms with notable goodwill will raise higher prices than those with a less favourable name or turnover. It is thus essential to farm and market in such a way that the goodwill of the estate increases on an annual basis. The good name of the farm together with respected goodwill eventually account for a price increase.

Another factor which influences the market value of wine farms is the location of the farm relative to other farms in its vicinity. Research indicates that the effect of the location on the final market value is not as large as expected when compared with the income utility generating attributes in other types of property such as cattle farms. The location can, however, be the decisive factor when buyers consider a specific property. Factors such as the distance from the market, the surroundings of the farm and the area in which the farm is situated play a definite role in the buying process. Many wine farms make use of unique marketing strategies to sell their products. Some of these strategies include catering for foreign tourists with the hope of entering foreign markets. It is therefore essential to develop the farm in such a way that it meets the needs of the seasoned tourists. An effort to market a wine farm which is not yet ready for the specific market can do more harm than good if a maximum market value is not an objective (Smith, 1998: 335).

4. Conclusion

An overall view of property valuation and the valuation of wine farms, in particular, indicates that much research needs to be done in South Africa. Regardless of the valuation method used, the answer should always be tested against another method or by applying market-related information. Practically all the data used in valuation equations are market-related. Hence, property valuation is a non-scientific field of study. Opinions differ and most valuers adhere to their own method.

Bibliography

AIREA

1983. Eighth Edition. *The appraisal of real estate*. AIREA: Chicago.

BEHRMANN, H.I.

1995. *Farm land valuation*. Department of Agriculture Economics, Pietermaritzburg: University of Natal.

ELLENBERGER, E.L.

1982. *The valuer*. Durban: Butterworths.

GILDENHUYS, A.

1976. *Onteieningsreg*. Durban: Butterworths.

HOFMEYER, D.

1997. *Personal notes on the valuation of farms*. Cape Town.

Smith/South African wine farm valuation

KINNARD, W.N.

1979. *Principles and techniques of real property appraising*. Mass.: Lexington Books.

MARITZ, N.G.

1983. *Business economics BEC306-3 (Market Valuation) Study Guide*. Pretoria: University of South Africa.

MURRAY, W.H.

1969. Fifth Edition. *Farm appraisal and valuation*. Iowa: Ames Iowa State University Press.

RATCLIFF, R.U.

1972. *Readings on appraisal and its foundation economics*. Wisconsin: University of Wisconsin Press.

SMITH, W.P.

1998. 'n *Ontleding van wynplaaswaardasie-metodologie in Suid-Afrika*. Departement van Argitektuur en Boukunde. Kaapstad: Kaapse Technikon.

SQUIRE, B.

1975. *South African property and the valuer*. Cape Town: JUTA.

SUTER, R.C.

1980. Third Edition. *The Appraisal of farm real estate*. Danville: Interstate Printers & Publishers Inc.